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New York Court of Appeals Holds That Claims for Breaches of Representations and Warranties Accrue When RMBS Contracts Are Executed

Last Thursday, the New York Court of Appeals issued an important opinion, *ACE Securities Corp. v. DB Structured Products, Inc.*, 2015 WL 3616244 (N.Y. June 11, 2015), explaining when the applicable six-year statute of limitations begins to run for breach of contract claims related to residential mortgage-backed securities (“RMBS”). The Court of Appeals unanimously held that claims for breaches of contractual representations and warranties accrue when RMBS contracts are executed, regardless of when the breaches were discovered and when corresponding demands to repurchase mortgages are asserted. In addition, the Court held that actions based on repurchase claims cannot be validly commenced before the contractual prerequisites are satisfied. The contractual prerequisites at issue required notice to the RMBS sponsor of the alleged breaches of representations and warranties and the expiration of a contractually mandated period for cure. This decision will provide certainty to RMBS issuers and mortgage originators by foreclosing stale claims related to legacy securitizations, and will establish a fixed period for evaluating exposure to potential repurchase claims for future RMBS issuances.

Background

The contracts governing nearly all RMBS include provisions under which RMBS sponsors, and in some instances originators of securitized mortgages, are obligated to repurchase individual mortgages from the RMBS trust at par value if certain contractual representations and warranties regarding the mortgages at issue are found to have been breached, and those breaches materially and adversely affect the value of the mortgages. In each securitization contract, upwards of one hundred separate representations and warranties may be applicable to each mortgage. Those representations and warranties typically address characteristics related to the quality of the mortgages and may include representations and warranties that the mortgage was originated in accordance with the applicable underwriting guidelines; that the amount of the mortgage loan did not exceed certain ratios with respect to the underlying property value; and that the mortgage was originated in compliance with applicable state and federal lending laws. Upon receiving notice of breaches or upon discovering breaches, the RMBS sponsor or mortgage originator will have a certain period of time to cure the breach, which is typically sixty to ninety days. If it fails to cure, it must repurchase the mortgage at issue from the trust.

In recent years, RMBS trustees and RMBS investors have filed dozens of actions against RMBS sponsors and originators of the securitized mortgages. In those actions, RMBS trustees and RMBS investors seek to compel repurchase of mortgages based on alleged breaches of representations and warranties. Each

action ordinarily asserts repurchase claims for hundreds, if not thousands, of securitized mortgages and seeks damages in the hundreds of millions of dollars. Nearly all of these actions arise from RMBS contracts executed before 2008, which incurred significant losses following the financial crisis.

Because many of these repurchase actions were filed in 2012 or later, a key issue for a substantial number of pending actions, as well as for potential future actions, is whether the repurchase claims accrued when the RMBS contracts were executed or when the repurchase claims were made by the trustee and denied by the issuer. If the claims accrued when the RMBS contracts were executed, then New York's six-year statute of limitations would bar a number of pending actions, and would preclude future repurchase actions related to pre-2008 RMBS issuances. If the claims accrued upon each discovery of a breach of a representation and warranty and denial of a repurchase claim, then the statute of limitations would effectively be extended through the life of the RMBS trust, which could be decades.

Procedural History

In this action, two investors in the ACE Corp., Home Equity Loan Trust, Series 2006-SL2 residential mortgage-backed securitization (the "Trust") issued a notice on January 12, 2012, alleging breaches of representations and warranties as to hundreds of mortgages securitized into the Trust. (Op. 5–6.) Purporting to act on behalf of the Trust, the investors then filed a summons with notice in New York Supreme Court on March 28, 2012, asserting a breach of contract claim against the sponsor of the Trust, DB Structured Products, Inc. ("DBSP"). The claim alleged that DBSP had materially breached its representations and warranties regarding the mortgages identified in the notice, and had failed to comply with its contractual obligation to repurchase mortgages after receiving notice of the alleged breaches. (Op. 6.) The summons with notice demanded specific performance of DBSP's repurchase obligations and damages totaling \$250 million. (Op. 6.) Six months after the investors filed the action, the trustee, HSBC, was substituted as the plaintiff and filed a complaint on behalf of the Trust. (Op. 6; *see* 40 Misc. 3d 562, 564 (N.Y. Sup. Ct. 2013).)

The summons with notice was filed exactly six years from the date that the underlying securitization agreements were executed, March 28, 2006 (Op. 4), but less than sixty days after the notice of alleged breaches had been delivered to DBSP. Under the contractual provision governing the repurchase claims, DBSP was entitled to sixty days from the date of notice to cure any breach. If DBSP failed to cure, it was required to repurchase the mortgages at issue within ninety days from the date of notice. (Op. 4–5.)

DBSP moved to dismiss the action as untimely. DBSP argued that the initial summons with notice filed by the investors was void because the contractually specified cure and repurchase periods had not expired when the action was initiated. (Op. 7.) In addition, DBSP argued that the Trust's claims would be time-barred. That was so, according to DBSP, because claims for breaches of representations and warranties accrued when the contracts were signed in 2006, and because the corresponding cure and repurchase

period for the notices of breaches would not have expired until more than six years after contract execution. (Op. 7.)

The trial court denied DBSP's motion to dismiss. The trial court held that the breach did not occur when the contracts were signed, but rather when DBSP failed to cure or repurchase the allegedly defective loans within the contractually stated periods "following discovery or receipt of notice of a breach of a representation or warranty." (Op. 7 (quoting 40 Misc. 3d at 566).) The court further reasoned that "[t]he whole point of how the [securitization agreements] were structured was to shift the risk of noncomplying loans onto DBSP," and the argument "that the trustee's claims accrued in 2006 . . . utterly belies the parties' relationship and turn[ed] the PSA on its head." (Op. 7–8 (quoting 40 Misc. 3d at 567).

Following an appeal by DBSP, the First Department of the Appellate Division reversed the trial court's decision and held that the Trust's claims were untimely. (Op. 8.) The First Department ruled that the Trust's claims for breaches of representations and warranties accrued in 2006 when the contracts were executed. The First Department also ruled that, while the investors commenced the action within six years of the closing date, the investors had not satisfied the condition precedent—affording DBSP sixty days to cure and ninety days to repurchase after notice of alleged breaches—before commencing suit. The failure to satisfy the condition precedent therefore "rendered [the investors' initial] summons with notice a nullity." (Op. 8.)

The Court of Appeals' Decision

The Court of Appeals affirmed the First Department's decision, dismissed the Trust's claims as untimely, and held that the repurchase claims accrued when the securitization contracts were signed.

The opinion first addressed when the claims for repurchase had accrued. The Court began by outlining the rationales underlying New York's statute of limitation for breach of contract claims. The Court stated that the limitation serves "the same objectives of finality, certainty, and predictability that New York's contract law endorses," and noted that New York law is in "favor of a bright line approach." (Op. 9.) New York law therefore does not apply a discovery rule in breach of contract cases; instead the "statutory period of limitations begins to run from the time when liability for wrong has arisen even though the injured party may be ignorant of the existence of the wrong or injury." (Op. 9.)

HSBC argued on behalf of the Trust that DBSP had a separate contractual obligation to cure breaches of representations and warranties or to repurchase the affected mortgages. According to HSBC, the Trust's claim therefore did not accrue until DBSP refused to cure or repurchase the allegedly defective loans. HSBC viewed DBSP's obligation to cure or repurchase "as a distinct and continuing obligation [and] a separate promise of future performance that continued for the life of the investment . . ." (Op. 10.) The Court, however, rejected this accrual-at-denial argument.

As the Court observed, DBSP made certain representations and warranties in the securitization agreements, and DBSP expressly stated that its representations and warranties did not survive the closing date. (Op. 12.) The Court reasoned that DBSP's cure and repurchase obligations were "dependent on, and indeed derivative of, DBSP's representations and warranties, which did not survive the closing and were breached, if at all, on that date." (Op. 12.) The Court further stated that "[t]he sponsor merely warrants certain characteristics of the loans, and promises that if those warranties and representations are materially false, it will cure or repurchase the non-conforming loans within the same statutory period in which remedies for breach of contract . . . could have been sought." (Op. 13.) Accordingly, the Court held that the repurchase claims accrued upon execution of the securitization agreements in 2006.

The Court then addressed HSBC's argument that the contractual condition precedent to a lawsuit, which afforded DBSP sixty days to cure and ninety days to repurchase from the date of notice before commencement of a suit, delayed the accrual of the cause of action. (Op. 14.) HSBC argued that the condition precedent was a substantive condition to the existence of any cause of action, as opposed to a merely procedural requisite to a lawsuit, and that the Trust's claims therefore did not accrue until expiration of the period for cure and repurchase. (Op. 14–15.) The Court was "unconvinced." (Op. 15.) The Court distinguished between "a demand that is a condition to a party's *performance*" and "a demand that seeks a remedy for a pre-existing wrong." (Op. 15.) In this case, the Court held that the required notice of the breach of representations and warranties and the corresponding cure period were only limitations on the Trust's remedies for the pre-existing breaches of representations and warranties. In the Court's view, DBSP's repurchase obligation was not a separate undertaking that delayed accrual; instead, "[t]he Trust suffered a legal wrong at the moment DBSP allegedly breached the representations and warranties." (Op. 15–16.) For that reason, the repurchase claims accrued upon the alleged breaches of the representations and warranties. Accordingly, the Court held that the Trust had six years to satisfy the conditions precedent and initiate the Action, which it failed to do. The repurchase claims were therefore time-barred. (Op. 17–18.)

Analysis

The Court of Appeals' decision holds that a cause of action based on breaches of contractual representations and warranties accrues when the representations and warranties are made. The decision also rejects the three core arguments that have been advanced by plaintiffs in RMBS repurchase actions. First, the decision rejects the argument that sponsors have an "ongoing obligation" to repurchase defective loans that lasts for the lifetime of the RMBS trust. Second, the decision rejects the argument that the sponsor's refusal to repurchase defective loans is itself a breach that gives rise to an independent cause of action. Third, the decision rejects the proposition that contractual provisions barring parties from commencing suit until the expiration of the cure and repurchase period delay the accrual of the action. This decision should substantially benefit financial institutions facing repurchase actions based on claims for breaches of representations and warranties that arise from legacy RMBS issuances. As a

practical matter, moreover, the decision should signal the death knell of new litigation arising from the financial crisis and should cabin the litigation exposures for RMBS issuers and mortgage originators.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel
(212) 373-3553
sbuergel@paulweiss.com

Charles E. Davidow
(202) 223-7380
cdavidow@paulweiss.com

Andrew J. Ehrlich
(212) 373-3166
aehrich@paulweiss.com

Brad S. Karp
(212) 373-3316
bkarp@paulweiss.com

Daniel J. Kramer
(212) 373-3020
dkramer@paulweiss.com

Lorin L. Reisner
(212) 373-3250
lreisner@paulweiss.com

Walter Rieman
(212) 373-3260
wrieman@paulweiss.com

Richard A. Rosen
(212) 373-3305
rrosen@paulweiss.com

Audra J. Soloway
(212) 373-3289
asoloway@paulweiss.com

Associates Yacoba E. Annobil, Caitlin E. Grusauskas, Harry M. Jacobs and Kevin P. O'Keefe contributed to this client alert.